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D/ALA

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Nicaragua: Prospects for the Economy

Summary

Nicaragua's economy has declined precipitously since the 1979 revolution. Personal income has dropped around 50 percent; GDP has plummeted more than a third; and inflation, fueled by a huge public sector deficit, is now running at an annual rate of 2,000 to 3,000 percent. The deteriorating economic situation is largely the result of Sandinista pummeling of the private sector. In addition, restrictive government controls and financial mismanagement have choked production by rewarding political supporters instead of seeking a positive return on investment. Moreover, a disastrous plunge in the trade balance has forced the Sandinistas to ignore debt servicing. This, in turn has reduced foreign assistance from many Western donors. While Soviet Bloc aid has increased, it has not kept up with Managua's needs. [redacted] 25X1

The limited reforms introduced during the spring of 1987 and early this year have failed to halt the economic slide. Additional reforms announced last week, if fully implemented, could partially boost productivity and help ease consumer shortages. The Sandinistas may backtrack on some of the reforms, however, as the result of pressure from political

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loyalists who have lost perks and who object to the reforms on ideological grounds. Even if the reforms are sustained or marginally expanded, we judge the Nicaraguan economy will need substantial foreign investment to recover fully. This will probably lead the regime to seek more normal diplomatic and economic relations with the United States through bilateral negotiations to discuss our strategic concerns in the region. 25X1

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An Economy Headed for Disaster

Virtually every economic indicator shows that the Nicaraguan economy has fallen to record depths since it began its post-Somoza decline in 1981, primarily because the regime has put political considerations ahead of economic ones.[1] In real terms, overall economic activity has fallen more than one-third below pre-revolutionary levels. Per capita income is roughly half its 1977 level, despite a nearly four-fold increase in economic aid since 1979. Inflation, which began spiraling in 1985, soared to annual rate of 13,000 percent earlier this year. Not surprisingly, exports have plummeted to about one third of that registered during the last years of the Somoza era.[2] In our judgment, economic policies driven primarily by political concerns are responsible for the steady deterioration in Nicaragua's economy. The regime has manipulated the economy in its effort to consolidate its power. As a result, the government now controls patronage to roughly half the jobs in the country and spends more than one-fourth of the GDP on the military. 25X1

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1 GDP rebounded in 1980 and 1981; but the expansion--based on ballooning government expenditures to increase social services, rebuild the war-damaged infrastructure, and strengthen the armed forces--proved unsustainable. For more detailed data on the economic decline, see the economic indicators graphs at the end of the text. 25X1

2 See graph, Nicaragua: Export Sales Breakdown, 1978-1988. 25X1

The regime's seizure of the economy from the private sector has caused, in our view, the most serious damage to production.[3] Although the Sandinistas claim to be building a mixed economy, blatant and capricious anti-business acts--including the uncompensated seizure of productive farms and businesses--have practically eliminated private investment incentives. Such intimidation has led to massive capital flight, driven many of the economic elite out of the country, and alienated the rest. The remaining private farms and businesses have deteriorated from lack of investment, and business leaders say that many landowners and manufacturers stay in Nicaragua only to protect their assets while hoping for a change in the government. 25X1

Tight bureaucratic controls also have choked production. For example, until recently, private farmers had to have their crop plans approved before planting; buy all their seeds, fertilizers, and insecticides from the government; hire labor from Sandinista unions at fixed wages; and sell their produce to the state at set prices. The government then distributed food and other consumer goods in priority order to the military, party members, workers in agriculture and industry, and the rest of the population. Prices often were set artificially low--or soon fell below costs because of high inflation--in order to provide party members with inexpensive food and other consumer goods, despite the fact that this inevitably resulted in shortages of goods for the general population. 25X1

Sandinista financial mismanagement has also impeded production, driven up the public sector deficit, and fed inflation. State farms and businesses received generous levels of credit at a government-imposed nominal annual interest rate of 48 percent. As the inflation rate climbed, credit ballooned because borrowers took out loans to buy luxury goods and other non-investment items. The huge losses inflicted on the state-owned banking system from the overwhelmingly negative interest rates have been exacerbated by transactions involving the fixed exchange rate. Party members, given priority access to increasingly scarce hard currency, have bought Western luxury goods at less than one percent their market value while private farmers have been denied dollars to purchase fertilizers, insecticides, and critical spare parts. Internal Sandinista studies state that the deficit also worsened because public investment, along with scarce foreign development funds, were wasted on long-term projects offering little, if any, return on investment. 25X1

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[3] See graph, Nicaragua: Public Sector Share of Arable Farmland and GDP, 1978-1987 and table, Nicaragua Exports. 25X1

Rapidly rising defense costs, especially since 1983, have siphoned off an increasing share of scarce resources. While insurgent attacks have caused some economic losses, the simple cost of maintaining a huge army has severely weakened the financial structure of the economy. The military now consumes 60 percent of the central government's budget and has been a major contributor in driving the public sector deficit from 6 percent of GDP in 1979 to over 50 percent last year. [redacted] 25X1

Impact on International Accounts

The depressed domestic output has had a major impact on Nicaragua's international accounts.[4] Plummeting exports have driven the trade balance from a $52 million surplus in 1978 to an average annual deficit of more than $500 million during the past three years. With debt service added to the trade deficit, the amount of assistance required to cover Managua's annual foreign obligations has soared from nearly zero in 1979 to more than $1.3 billion last year--equivalent to more than half of the country's annual GDP. [redacted] 25X1

While creditors have responded generously to Sandinista calls for debt reschedulings, loans, and credits, foreign assistance has not increased fast enough to meet Managua's import and financial needs. Last year, imports were 25 percent lower than 1981 levels in current dollars, worsening consumer shortages, particularly in the cities. As a result, since 1981 the Sandinistas have been increasingly inclined to ignore their debt obligations, alienating commercial banks, multilateral organizations, and many bilateral Western lenders in the process. The regime has been able to replace the monetary value of lost Western aid with assistance from the Soviet Bloc. Soviet Bloc aid, however, has been mostly technical assistance and low quality goods rather than production-enhancing investment funds and capital goods previously supplied by the West.[5] By 1986, moreover, Moscow was beginning to demand some payment for its assistance and started to question Managua's constant requests for more aid, charging that much of it was being wasted. [redacted] 25X1

Forced to Implement Limited Market Reforms

The gap between falling production and the ever-increasing need for foreign assistance had widened enough that by early 1987 the Sandinistas' were forced to face the underlying causes of their deteriorating economy. In May and June 1987, the regime abruptly modified its policy of expanding state control and

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[4] See table, Nicaragua: Balance of Payments, 1979-1987. [redacted] 25X1

[5] See graph, Nicaragua: Annual Economic Assistance by Major Source, 1979-1987. [redacted] 25X1

25X1

adopted some market-oriented reforms. Salaries were indexed to inflation and some price and distribution controls were eased. The regime even made token overtures to the private sector, including notifying large landowners that agrarian reform had run its course, negating the need for further property confiscations. [redacted] 25X1

These measures failed to revive the economy, however, because the underlying causes of the economic crisis--including price and wage controls and the deficit--were not addressed. By early 1988, shortages of oil and other imports were crippling production and soaring inflation was destroying Nicaragua's currency and undermining the Sandinistas' hold on the economy. Chronic energy shortages idled farm machinery during peak harvest season and led Managua to close many of the country's factories. As inflation reached stratospheric levels, black marketeering, where barter and dollars replaced the near-worthless cordoba, accelerated. [redacted] 25X1

In February, to avert impending disaster and to try to shock the economy back to life, the regime announced additional reforms. The measures included introducing a new, highly-devalued currency, reestablishing a uniform exchange rate, dramatically realigning distorted prices and wages, and making large spending cuts in public investment and social services. To oversee the changes and improve operations, the regime shuffled its economic decisionmakers into new posts and streamlined the bureaucracy, including freeing the operations of state-controlled farms from the Agriculture Ministry. [redacted] 25X1

Managua's insistence, however, on maintaining price, wage, and exchange rate controls while the economy adjusted to the measures succeeded only in further undercutting production. Many businesses became unprofitable overnight because most of the new state-set prices failed to compensate for the huge increases in production and import costs. Cotton farmers refused to plant their spring crops, and labor strikes paralyzed the construction and auto repair industries. In addition, a critical cash shortage jolted the economy because individuals and institutions --including large businesses--were not permitted to exchange more than $200 worth of old currency. The remainder is being held in frozen bank accounts. [redacted] 25X1

In our view, the threat of further economic deterioration led the regime to reluctantly open the economy even further last week. Managua eliminated many wage and price controls, implemented an 85 percent devaluation of the cordoba against the dollar, increased credit to farmers with political ties to the regime, and indexed interest rates and the exchange rate to inflation. The regime, however, made it clear that such measures did not mean that the Sandinistas were renouncing Marxist-

Leninism. In a speech announcing the measures, Ortega admitted that the reforms are a tactical necessity to protect the revolution. He threatened to "bury" the private sector if it fails to respond by increasing production and investment. 25X1

The Coming Year

To the extent that the Sandinistas allow market forces to correct the distortions created by eight years of economic controls, we believe that productivity will partially recover and economic pressures on the population may ease somewhat. Despite their ideological opposition to market forces, the Sandinistas are likely to stick with the measures for at least the next several months to see if production rebounds. Producers operating with little capital--such as small grain farmers--almost certainly will increase output if a profit can be made. Other farmers and businessmen who cut back after the announcement of the February measures, rather than produce at a loss or risk government sanctions by selling on the black market, most likely also will expand production, using the excess capacity of their factories and equipment. Likewise, farmers and manufacturers producing primarily for the export market probably will respond positively to the reforms since many of their goods cannot be sold in large quantities on the domestic black market. 25X1

Numerous constraints, however, will keep production increases modest. Output will be limited by the government's insolvency and increasingly dilapidated infrastructure. Ortega's speech was vague on many specifics, such as the private sector's access to foreign exchange to buy spare parts and other imports. The regime could negate many potential benefits by retaining or tightening export controls. 25X1

Inflation--which we believe will not be substantially reduced unless defense spending is slashed--presents the greatest challenge to increasing production. Even though freeing wages and prices removes a major production obstacle, the measures also are inherently inflationary. The current inflation rate of 25 to 35 percent per month presents problems for business people trying to calculate costs and adjust prices. If, however, the higher rates brought on by the reforms are sustained beyond a few months, productivity will suffer because more of the economy will slip into the less efficient black market system, and the currency will again be in jeopardy of losing its transaction value. 25X1

Faced with discontent within the party, the Sandinistas could backtrack on the reforms. The minor concessions to political loyalists--including increased credit for state farms and cooperatives--could easily fail to buy their support, forcing the Sandinistas to choose rescinding some of the measures or losing political support. According to press reports, the crowd of 1,000 party loyalists in attendance when Ortega announced the reforms was sometimes hostile, concerned that he was abandoning the socialist goals of the revolution. Furthermore, nearly all groups within the party will likely want to dump those reforms that have taken away their access to cheap hard currency, gutted education, health and other social programs, and is forcing state-controlled farms and businesses to compete more equally with private producers. 25X1

If political repercussions from the latest reforms prove manageable, the regime may offer additional minor reforms, such as improved access to credit for private farmers. In our view, however, they would not relinquish fundamental control over the economy. Even though current or new reforms may provide producers with some breathing space, the regime still will have the ability to manipulate all significant economic sectors through its control of banking, distribution, and international trade. 25X1

<u>**Obstacles to a Full Recovery**</u>

In our judgment, the prospects for a major revitalization of the economy are extremely limited. Because of poor relations with the United States and traditional lenders--such as commercial banks--the Sandinistas are unlikely to attract the billions of dollars in investment needed to bring the Nicaraguan economy back to pre-revolution production levels. Even if the war ends and Managua cuts defense spending in half, the Nicaraguan economy already is too weak to rebound quickly. Ortega's venomous attacks on the private sector during his speech last week offset the welcomed reforms; and business people almost certainly will remain reluctant to risk major investments. Furthermore, the cash-strapped Soviets, while interested in maintaining the Sandinistas in power by providing oil and vital foodstuffs, have shown no signs that they are willing to invest heavily in the rebuilding of Nicaragua. 25X1

We judge that the Sandinistas will seek to improve relations with Washington to generate additional financial resources and remove the US trade embargo. The regime most likely will continue to portray itself the "victim" of the Reagan Administration and make an all-out effort to woo the next US President by pushing for bilateral negotiations to discuss our strategic interests. The Sandinistas almost certainly realize that good relations with Washington also could give them access to development funds from other sources, including multilateral organizations and Western Europe. Meanwhile, Nicaragua will vigorously pursue war reparations from the US through the International Court of Justice in order to gain bargaining leverage. 25X1

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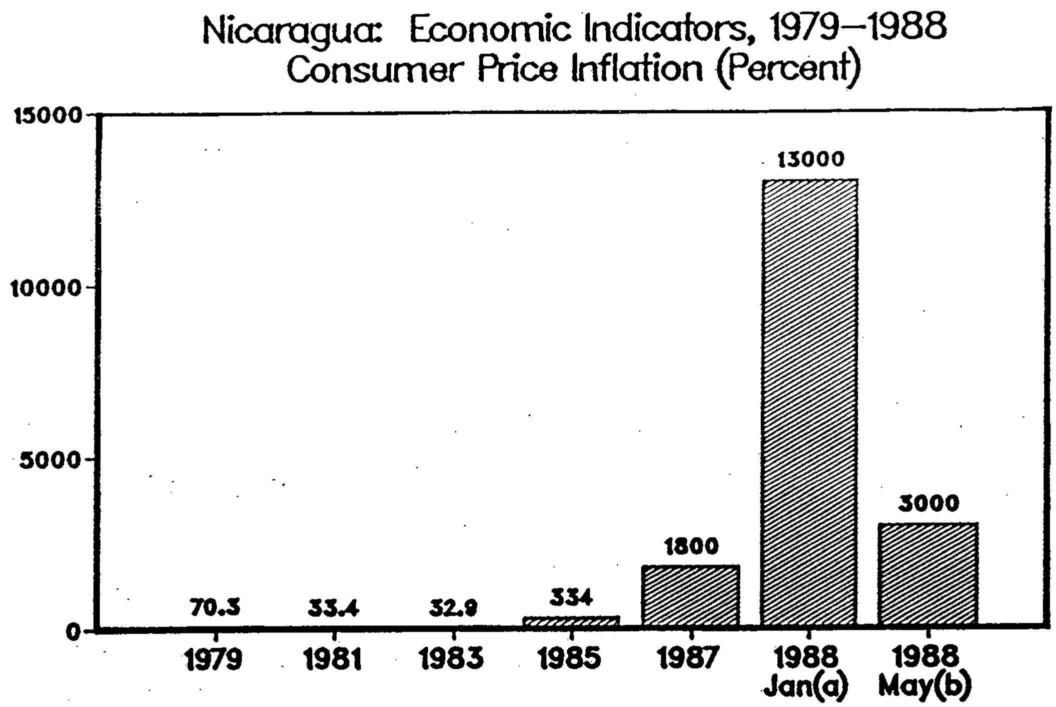
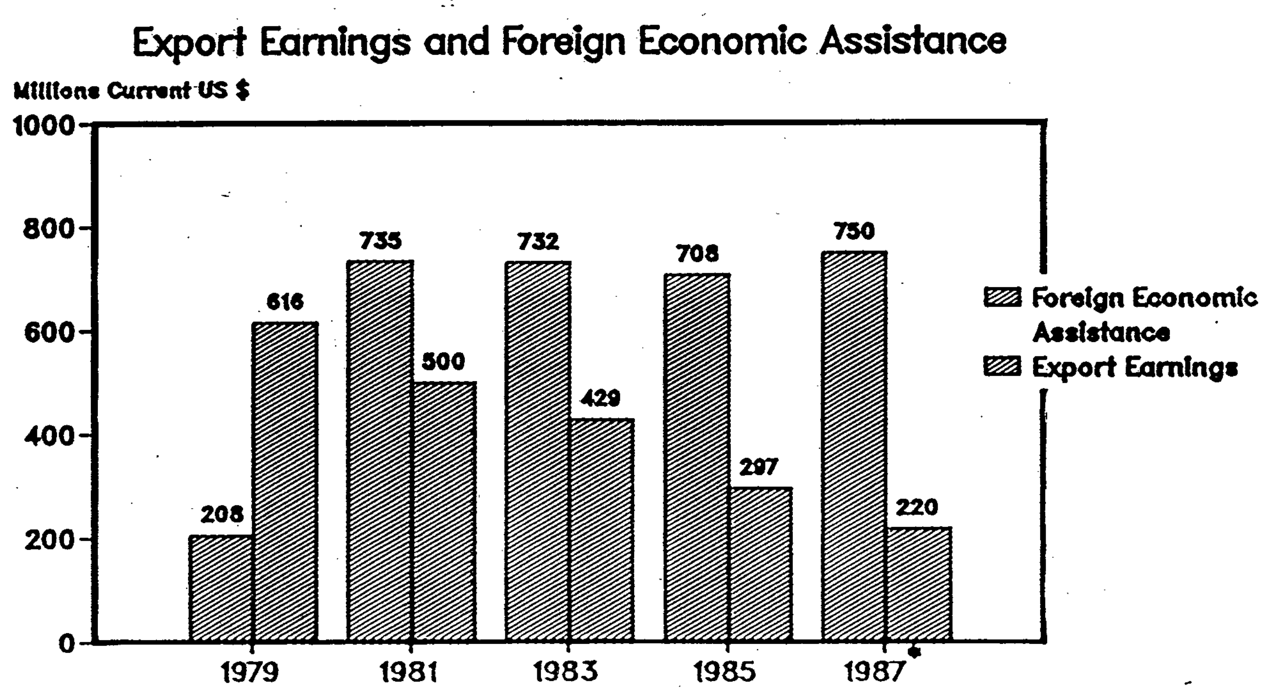


a Annual rate during the quarter ending in January.
b Annual rate during the quarter ending in May.



* Estimated

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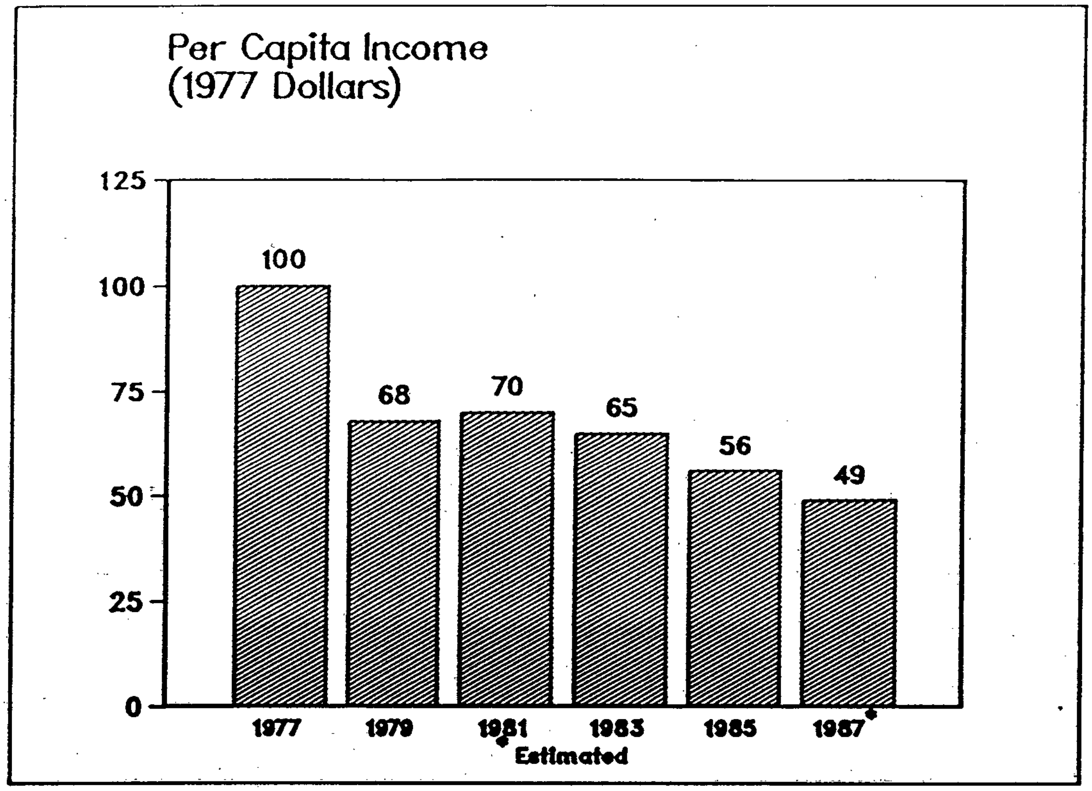
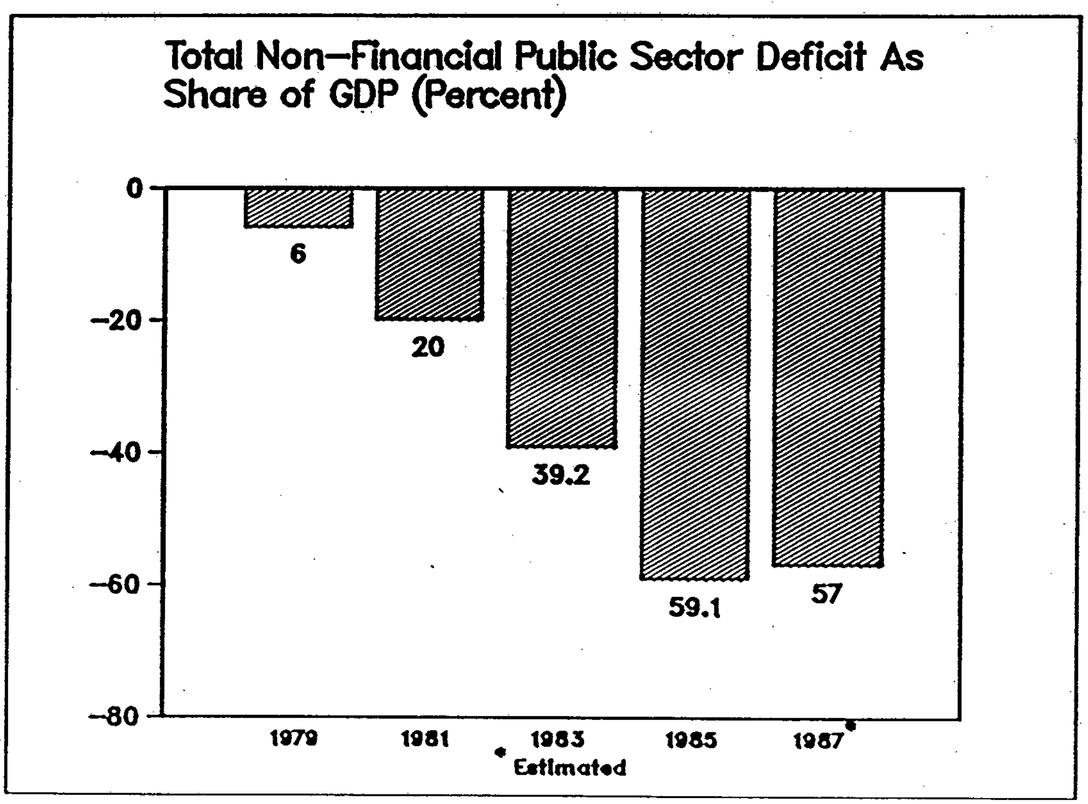
NICARAGUA: ECONOMIC INDICATORS, 1979–1987





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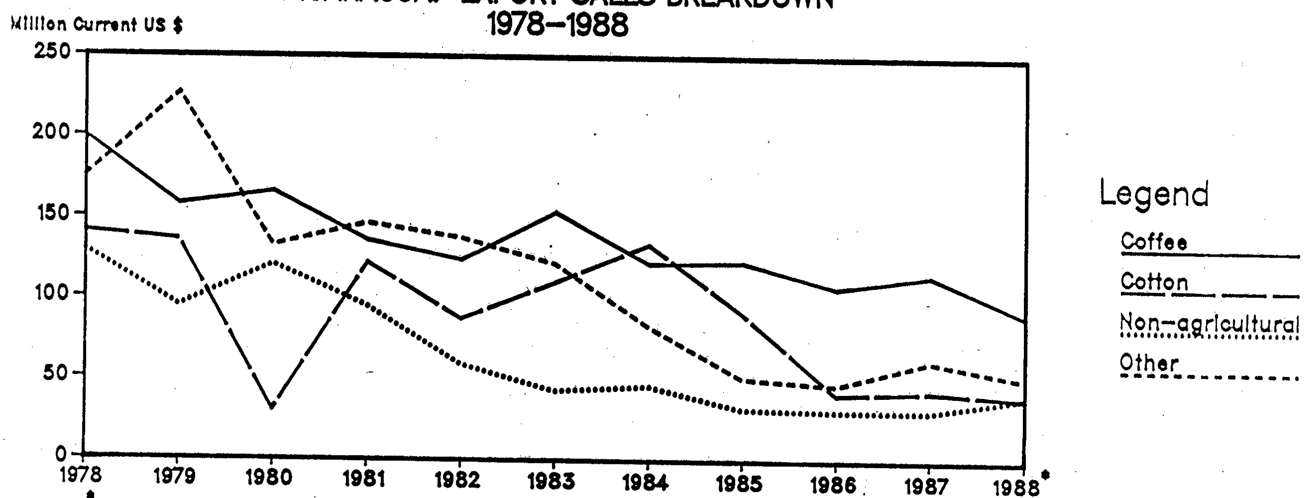
NICARAGUA: EXPORT SALES BREAKDOWN 1978–1988



* Projected

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988*
Coffee	200	158	166	136	124	154	122	123	107	115	90
Cotton	141	136	30	122	87	110	134	91	41	43	39
Non-agricultural	130	95	121	95	59	43	46	32	31	31	40
Other	175	227	133	147	138	122	83	51	47	62	51

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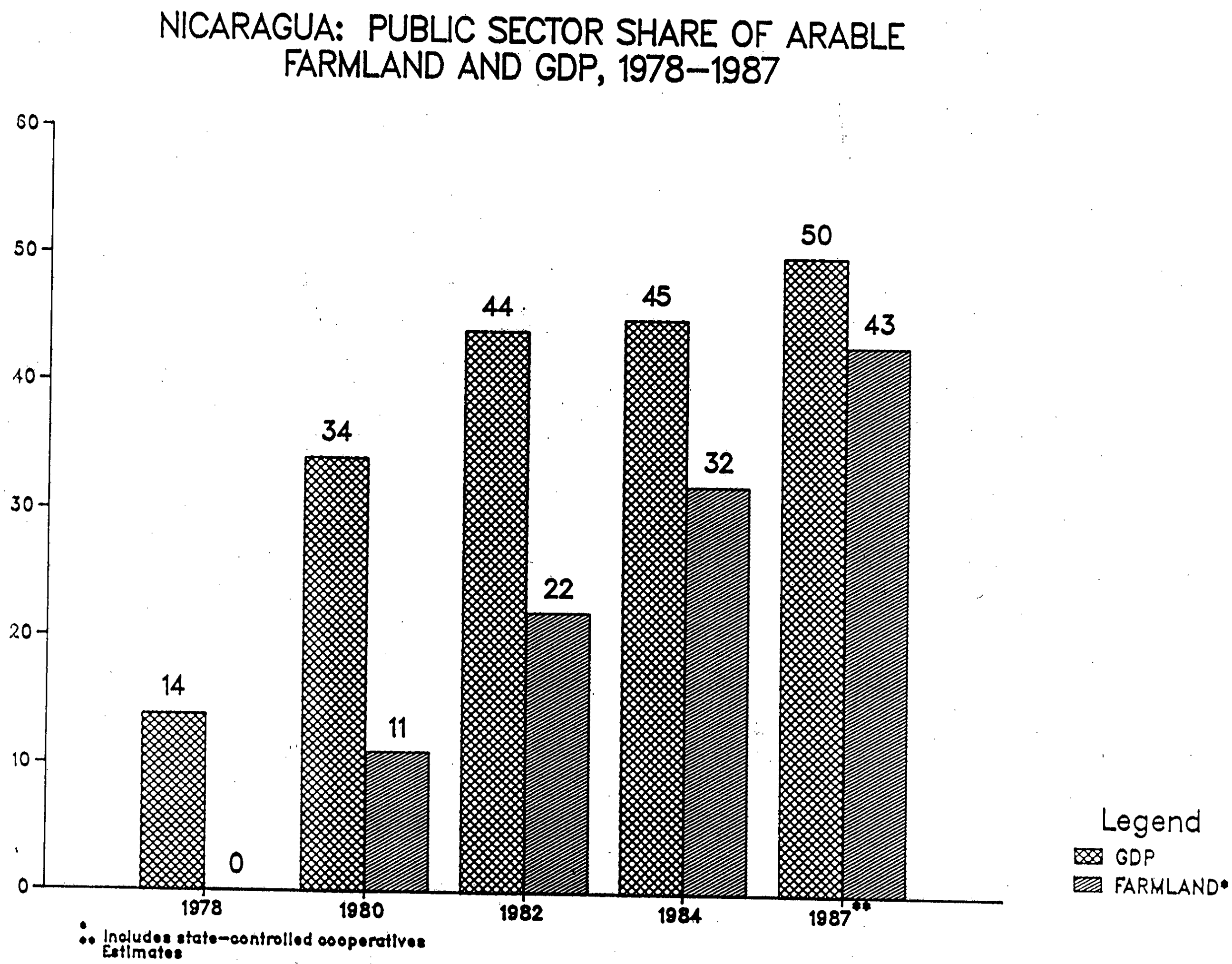
NICARAGUA: PUBLIC SECTOR SHARE OF ARABLE FARMLAND AND GDP, 1978–1987
60
50
40
30
20
10
0
14
0
34
11
44
22
45
32
50
43
1978
1980
1982
1984
1987**
Legend
GDP
FARMLAND*
* Includes state-controlled cooperatives
** Estimates

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Nicaragua Exports (Millions US $)

	1987	1988 PLAN	1988 CIA ESTIMATE
COFFEE	115	107	90
COTTON	43	62	39
BANANAS	14	21	14
SEAFOOD	13	25	17
SUGAR	8	13	5
SESAME	3	5	3
MEAT	13	13	12
GOLD	15	21	20
OTHER	27	49	21
TOTAL	**251**	**316**	**221**

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Nicaragua: Balance of Payments, 1979-1987

(Millions US Dollars)

	1979	1980	1981	1982	1983	1984	1985	1986	1987
CURRENT ACCOUNT	180	-392	-563	-515	-565	-666	-856	-764	-879
Trade Balance	227	-353	-422	-318	-349	-414	-545	-519	-479
Exports, f.o.b.	616	450	500	406	429	386	297	226	251
Imports, f.o.b.	-389	-803	-922	-724	-778	-800	-842	-745	-730
Net Services and Transfers	-47	-39	-141	-197	-216	-252	-311	-245	-400
CAPITAL ACCOUNT	-120	190	583	296	363	460	630	-139	135
Official disbursements	115	371	424	455	375	416	598	625	560
Debt amortization due	-117	-130	-97	-113	-341	-166	-192	-690	-500
Rescheduled debt*	138	135	92	27	418	247	154	74	125
Other capital and errors and omissions	-256	-186	164	-73	-89	-37	70	-148	-50
OVERALL BALANCE	60	-202	20	-219	-202	-206	-226	-903	-744
Increase in arrears			37	78	254	202	4	827	669
Net change in reserves	60	-202	57	-141	52	-4	-222	-76	-75

*Includes conversion of Central Bank short-term liabilities from previous arrears into medium-term debt

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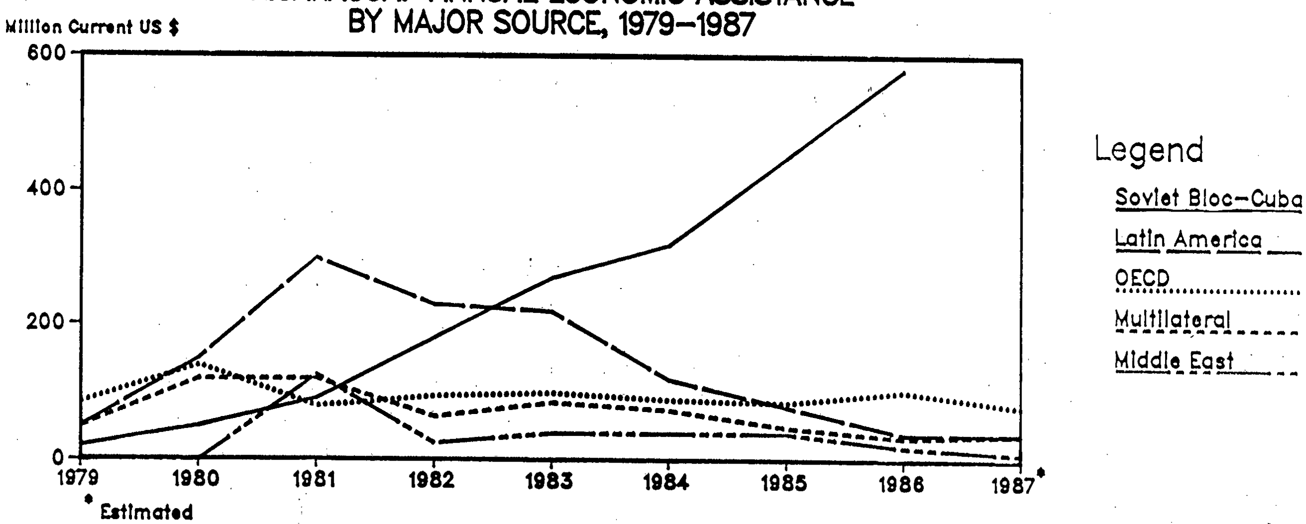
NICARAGUA: ANNUAL ECONOMIC ASSISTANCE BY MAJOR SOURCE, 1979–1987



	1979	1980	1981	1982	1983	1984	1985	1986	1987
Soviet Bloc–Cuba	20	50	90	180	270	320	450	580	535
Latin America	50	150	300	230	220	120	80	40	40
OECD	85	140	80	95	100	90	86	103	80
Multilateral	50	120	120	65	86	75	50	35	40
Middle East	0	0	125	25	40	40	40	20	10

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